

APPENDIX A

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Implementation of the Pay Telephone
Reclassification and Compensation Provisions
Of the Telecommunications Act of 1996

CC Docket No. 96-128

Petition for Rulemaking or, in the Alternative,
Petition to Address Referral Issues in Pending
Rulemaking

DA 03-4027

DECLARATION OF RICHARD CABE, Ph.D.

1. My name is Richard Cabe. I hold a Ph.D. in Economics.
2. I am providing this Declaration in support of the Comments of T-NETIX, Inc. and Evercom Systems, Inc.

BACKGROUND AND EXPERTISE

3. I am an economist in private practice, specializing in economic analysis of the telecommunications industry. I have presented testimony in matters concerning competition in the telecommunications industry to the public utility commissions of Alabama, Alaska, Arizona, Colorado, Florida, Georgia, Iowa, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Nevada, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Texas, Utah and Washington. I have also prepared declarations to be filed before the FCC and assisted in preparation of comments filed before the FCC.

4. From August 1990 through May of 1999, I was employed as Associate Professor of Economics and International Business at New Mexico State University. In that position, I taught graduate and undergraduate economics courses and arranged the telecommunications curriculum for conferences sponsored by the Center for Public Utilities. Over my last several years at the university, I offered graduate courses in Industrial Organization, Microeconomic Theory, Antitrust and Monopoly Power, Game Theory, Public Utilities Regulation, and Managerial Economics for MBA students.

5. My experience with telecommunications regulation began in January of 1985 when I was employed by the Washington Utilities and Transportation Commission. During my employment at the Washington Commission, I served as a staff member to the Federal - State Joint Board in CC Docket No. 86-297. When I left the Washington Commission staff to complete my doctoral degree, my title was Telecommunications Regulatory Flexibility Manager.

My consulting clients since I left the Washington Commission have included aspiring new entrants into the local telecommunications market, state commissions, and consumer advocates.

6. The purpose of this Declaration is to respond to the proposal for rate cap regulation contained in the Alternative Wright Petition and accompanying Dawson Declaration. These issues have been addressed before in this docket, and I will repeat points raised in my earlier declarations, the affidavit of Alan Schott, and the CapAnalysis report filed with earlier comments.

7. I find that the cost information advanced in petitioners' Alternative Rulemaking Proposal and accompanying Dawson Declaration is inappropriate to the task of establishing a price cap regime, and that price caps, even with the correct information at hand, would not be the appropriate regulatory tool in the market for inmate communications services. I conclude, as I did in my earlier Further Declaration in this docket, that site commissions are a cost of providing inmate communications services under the present institutional structure of the industry, and that any regulatory intervention that denied providers the opportunity to recover the cost of commissions required by contract would not allow a provider "to recover its total costs from its aggregate revenues."¹

EARLIER DECLARATIONS IN THIS DOCKET

8. My Declaration and Further Declaration were included in comments and reply comments filed by T-NETIX in this Docket on May 24, 2002, and June 24, 2002.

9. In my previous Declarations, I discussed the market for inmate calling services as one in which competition is vigorous among providers responding to facilities' requests for proposals.

10. Evidence of effective competition is found in the wide use of competitive bidding, with adequate numbers of qualified bidders indicating an absence of substantial barriers to entry. This finding was corroborated by an examination of five years of one provider's results of operations, showing no evidence of more than a competitive return.

11. I also discussed the role of site commissions as the mechanism by which facilities use competition among providers to extract location rents from those who pay for inmate communications services. I discussed advantages and disadvantages of three possible policy approaches to reduce rates for inmate communications services: debit or prepaid accounts, rate caps, and prohibition or limitation of location rents. I concluded that while the use of debit or prepaid accounts holds some promise to reduce the cost of inmate communications services, it can reduce but not eliminate the cost of billing and collection.

12. I also discussed the possible role of rate caps and found that variation in cost among facilities would result in a simple rate cap plan being ineffective or counterproductive,

¹ *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, Order on Remand and Notice of Proposed Rulemaking, FCC 02-39, Released February 21, 2002 (*Order and NPRM*) at ¶ 23.

and the usefulness of a more complex rate cap plan would be greatly limited by administrative cost.

13. In the event that the Commission were to consider a rate cap, my earlier Further Declaration noted the Commission's observation that "[t]o have a realistic chance of winning a contract, the bidder must include an amount to cover commissions paid to the inmate facility."² When a contract between a confinement facility and an inmate communications service provider is signed, those commissions become a cost to the provider that is necessary to the provision of service. Any rate cap plan that failed to recognize these costs would deny the provider an opportunity to recover legitimate costs that were essential to the provider's winning the contract. Without committing to pay commissions the provider had no "realistic chance of winning a contract," and when the contract takes effect the provider is obligated to pay commissions as a condition of providing service to inmates at that facility.

THE DAWSON DECLARATION IS MISTAKEN ABOUT COST AND PROFIT

14. The Dawson Declaration begins with rates for inmate calling service, subtracts an estimate of commission payments and cost, and concludes that the residual is profit to the inmate calling service provider. All reported calculations are made on a per-minute basis. This calculation is seriously flawed and not helpful for its intended purpose.

15. First, the Commission has noted that the relevant costs are not 'caused' by usage; they do not arise as costs per-minute of use.

16. The lion's share of payphone costs are those that are "shared or common" to all services, like the equipment expense and line charges. There are no logical or economic rules that assign these common costs to "each and every call." Thus, as the Commission recognized in the *Third Report and Order*, "because most payphone costs are fixed and each type of call has a relatively small marginal cost, a wide range of compensation amounts may be considered 'fair.'"³

17. While it can be convenient to state costs on a per-minute of use basis, it can also be misleading, as it is in the present context. In particular, while costs that actually vary with usage will be different on a per-minute basis at different facilities, the 'lion's share' of costs, which do not vary with usage, take on different values at different facilities when expressed on a per-minute basis, even when the underlying level of total cost is the same. This is a simple consequence of dividing a fixed cost by a volume of usage that varies across facilities. Thus, by referring only to cost on a per-minute basis, the Dawson Declaration confounds two sources of variation in cost among facilities; there are variations in total cost and there are variations in cost per-minute that arise from differences in call volumes.

² *Order and NPRM* at ¶ 10.

³ *Id.* at ¶ 16 (citing CC Docket No. 96-128, *Third Report and Order*, 14 FCC Rcd. 2545, 2570 (1999)).

18. Next, deficiencies of the cost estimate relied on in the latest Dawson Declaration have been noted in earlier comments in this docket.⁴ Related to the Dawson Declaration's single-minded attention to costs on a per-minute basis, previous comments note the earlier Dawson Declaration's flawed assumptions regarding 'typical' or 'average' calling volumes and numbers of phones required. Specifically, where the concept of economies of scale is mentioned, as at ¶ 31, the treatment is overly broad. Some economies of scale are achieved at the company level, others are achieved at the facility level. It is certainly not true that the cost of providing service to 100 facilities of 30 inmates each is likely to be the same as the cost of providing service to a single facility of 3000 inmates. Yet this is what would be required to reach the Dawson Declaration's conclusion that the federal debit card rate provides an indication of the cost of serving very different collections of facilities.

19. Particularly troublesome for the intended application of the cost estimate is the omission of the costs of research and development necessary to improve quality and decrease cost of service. The Dawson Declaration's conclusion that providers of inmate communications service are achieving "excessive" levels of profit rests heavily on the estimate of cost being exhaustive — including all costs that are necessary to provision of the service at issue — and such reliance is not justified.

20. Further, there is no basis for concluding that any particular margin of profit on revenue is "clearly excessive" as the Dawson Declaration does at ¶ 28. The comparison to margins common to non-inmate long distance services does not support the inference that particular margins stated on a per-minute basis are "clearly excessive" in the inmate communications service context. As noted above, the relevant costs do not arise as costs per-minute, but as costs that are shared or common, and largely fixed for each facility, and calling volumes will be very different among facilities — not comparable at all to commercial long distance service.

21. As discussed further below, design of a reasonable rate cap plan for this industry requires knowledge of the structure and level of the cost of providing service, and particular attention must be devoted to high cost facilities, which may be unable to find a provider willing to offer service if the rate cap is set below the high cost facility's cost of service. Thus, cost information to support design of a rate cap for inmate calling services must focus on the cost of serving high cost facilities — ostensibly the smallest facilities, those located in remote areas, and those with low calling volumes arising from limited inmate access to communications services. Yet, the inferences regarding cost of service, excluding commissions, on which the Alternative Proposal relies are clearly selected from the low cost end of the spectrum.

22. The Dawson Declaration derives an indication of the cost of service, including profit but excluding commissions, by observing rates charged and subtracting an amount for commissions. For debit calls alone, the resulting indication of cost (including profit but

⁴ Comments of T-NETIX, Inc. dated March 10, 2004 and attached Affidavit of Alan Schott (Schott Affidavit) and report of Jeffrey Eisenach, *et al.*, *Mandatory Unbundling: Bad Public Policy for Prison Payphones* (CapAnalysis Report).

excluding commissions) range from \$0.10 per-minute⁵ to \$0.40 per-minute.⁶ Yet, higher indications are dismissed as “clearly excessive” profit margins,⁷ and attention is focused on lower indications:

It is not necessary or appropriate to look at higher inmate service rates than these examples because, in the absence of competition, even the lowest rates in comparable situations must be presumed to be significantly profitable.⁸

23. Regarding existing rates as data that may convey information about cost, the only safe thing to presume is that *ex ante*, when entering into the contract, the provider expects that the rates will cover cost, including a reasonable profit, and the facility expects that the chosen provider will meet its objectives better than other bidders. The very wide variation among cost indications could be explained by any of several possibilities, including the possibility that the rate differences are justified by differences in the inherent costs of providing service to the facilities in different locations, with different inmate populations, having different access to communications services, and serving facility administrations with different technical requirements. Insofar as rate differences suggest cost differences, the examples provided suggest a very wide variation among facilities, and, as discussed further below, great diversity in cost makes benchmark pricing a particularly unattractive regulatory alternative. In any case, if a rate cap is to be used, it should not be set at such a level that the cost of serving some facilities — the least attractive facilities — cannot be recovered at prices at or below the cap.

A RATE CAP PLAN IS NOT APPROPRIATE FOR INMATE CALLING SERVICES

24. The Petitioners’ Alternative Rulemaking Proposal seeks application of benchmark rates to all interstate, interexchange inmate calling services, proposing a benchmark rate in the range of \$0.15 - \$0.20 per-minute for debit card calls and in the range of \$0.20 - \$0.25 for collect calls. Such an approach would, at least, impose a heavy regulatory burden on an industry that shows no indication of lack of competition. If the structure of rate caps is badly designed, or if the levels are chosen badly, both of which are indicated in the present proposal, substantial disruption in the delivery of inmate communications services is likely.

25. A rate cap regime must use a structure that reasonably reflects the structure of costs of the services being regulated. The proposal recognizes a cost difference between debit calls and collect calls, but does not reflect any other cost differences that may exist among the services and facilities to which the plan would apply. Such cost differences are likely to arise

⁵ Dawson Declaration at ¶ 32, referring to a Missouri rate.

⁶ *Id.* at ¶ 24, referring to a rate in Colorado.

⁷ *Id.* at ¶ 28.

⁸ *Id.* at ¶ 33. As explained at some length in earlier comments, competition among providers responding to facilities’ requests for proposals is robust, and no provider can exercise market power in that market. The facility, of course, can specify contract terms in its request for proposals, constrained only by the cost to potential providers of delivering whatever the facility requests. The Alternative Rulemaking Proposal and accompanying Dawson Declaration offer no evidence that the competitive bidding process widely used in the industry fails to reach a competitive result.

from several factors. Some confinement facilities are intentionally located in extremely remote locations, while others are in urban areas with excellent access to transport facilities. Beyond variation in the cost of communications transport to serve confinement facilities in different locations, the cost of on-site maintenance of equipment is likely to vary substantially between locations, with remote locations being more costly to serve.

26. Economies of scale — or the lack thereof — are likely to cause substantial unit cost differences among confinement facilities. For most purposes, scale may be adequately measured by call volume, and variation in call volume arises from variation among facilities' inmate populations, as well as variation in policy-determined parameters of inmate access to communications services. The size distribution of confinement facilities, measured by inmate populations, covers a wide range. The largest and smallest facility size categories in available statistics both show substantial populations; on June 30, 2000, there were 258,840 inmates reported confined in prisons with populations of 2,500 or more, and on June 30, 1999, there were 32,788 inmates reported confined in jails with populations of less than 50.⁹ It is simply implausible that a single number could provide a reasonable rate benchmark for debit calling service or collect calling service, given the wide range of variation among facilities in the underlying determinants of cost — even if the single number were developed flawlessly.

27. Notably, the Alternative Rulemaking Proposal is silent on the issue of variation in cost among confinement facilities, yet this issue is crucial for design of a reasonable rate benchmark. If the rate benchmark is set so that the cost of serving a high cost facility is greater than the benchmark, then that facility will find it difficult or impossible to attract a provider. Thus, setting the benchmark too low creates the risk that the regulatory intervention intended to lower the cost of services to inmates and their families will leave some with no service, or service of unreasonably low quality. Setting the benchmark conservatively high to avoid this problem limits the benefit that might flow from capping rates at all. In general, the broader the range of costs among facilities, the less attractive is the regulatory approach of benchmark pricing.

28. An understanding of the influence these underlying determinants have on cost could support a more sophisticated selection of benchmark rate, or design of a more sophisticated rate cap plan, but such sophistication would come with an increase in administrative cost. To my knowledge, such an understanding of the precise quantitative relationship between cost of providing inmate communications services and the various relevant attributes of facilities has not been developed; it is certainly not offered in the proposal under consideration. Under the existing regime of competition, local costs and expected call volumes are taken into account when providers respond to a request for proposals specific to a facility or group of facilities, and the process of competitive bidding in response to a Request for Proposal will yield a much more reliable estimate of the minimum cost of serving specific facilities than could be attained through any regulatory proceeding.

⁹ Census of State and Federal Correctional Facilities, 2000 and Census of Jails, 1999, US Department of Justice, Office of Justice Programs, Bureau of Justice Statistics.

29. Further, the benchmark as proposed predetermines rate design as either a flat per-minute charge, or a flat per-minute charge after some unspecified amount of free calling. While such rate designs may not be unreasonable, they are certainly not the only reasonable rate designs, and they are a departure from the industry's conventional rate structure. -The Commission's observation in the *Order and NPRM*¹⁰ regarding allocation of common costs to services or calls applies also to rate elements.

30. Beyond the broad parameters outlined above for cost allocation, valid economic theory does not provide any basis to determine what precise portion of common costs a particular service, or for that matter any one call must bear. Particular policy goals may dictate a particular cost allocation, however.

31. Presumably, the correctional context may entail policy goals advanced by a particular rate design that the Commission may not wish to disturb. If the Commission were to prohibit location rents, rate design to accomplish particular policy goals could be an avenue for innovation and a subject of negotiation between a facility and potential providers, yet this avenue would be foreclosed under the unnecessarily regulatory benchmark rate approach.

32. Finally, the suggestion that "it is not necessary or appropriate to look at higher inmate service rates"¹¹ is seriously mistaken. It is precisely the high-cost facilities that raise concerns in setting a single rate cap to apply to many facilities with a range of costs.

CONCLUSION

33. The Alternative Rulemaking Proposal for benchmark pricing recommends a regulatory intervention that is particularly unsuited to an industry segment characterized by vigorous competition in the form of competitive bidding in response to requests for proposals, and dramatic variation in cost among facilities. Further, the inferences regarding cost set out in the Dawson Declaration are seriously flawed in concept and method and should not be used to support any form of benchmark pricing.

34. This concludes my Declaration.

I declare under penalty of perjury that the foregoing is true and correct.



¹⁰ *Order and NPRM* at ¶ 19.

¹¹ Dawson Declaration at ¶ 33.